FARM CREDIT ADMINISTRATION
UNITED STATES DEPARTMENT OF AGRICULTURE
WASHINGTON, D. C.

# AGRICULTURAL COOPERATIVES AND FEDERAL INCOME TAXES

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Miscellaneous Report No. 44

November 1941

FARM CREDIT ADMINISTRATION

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Agricultural cooperative associations are finding the exemptions from Federal income taxes granted by acts of Congress increasingly important. Since this is true and since the application of the principles of exemption is becoming more complex as farmers' cooperatives themselves become more complex, this entire subject is being studied. The purpose of these studies is to clarify the application of the principles of exemption to the actual operations of agricultural cooperatives.

This is one of several publications to be issued dealing with the income tax problems of farmers' cooperative associations.

# AGRICULTURAL COOPERATIVES AND FEDERAL INCOME TAXES 1/

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Unless an agricultural cooperative marketing or purchasing association is exempt from the payment of Federal income taxes, it is subject to the payment of all Federal taxes of every kind and character to the same extent and on the same basis as other business corporations. This emphasizes the significance to an association of exemption from the payment of Federal income taxes.

As indicated, if a cooperative association is exempt from the payment of Federal income taxes, it is also exempt from the payment of excess profits taxes, capital stock taxes, documentary stamp taxes on the issue and transfer of stocks, bonds, certificates of indebtedness and other securities, and also to a limited extent from the payment of social security taxes.

Every Federal income tax statute, except that enacted in the sixties to finance the Civil War, has contained a provision exempting agricultural cooperative associations from the payment of such taxes. The scope and terms of the exemption language which was included in the earlier income tax statutes varied considerably. Generally, the exemption provisions appearing in a later income tax statute were broader and more comprehensive than those which appeared in the preceding one. In 1926, however, an income tax statute was enacted which contained provisions for the exemption of agricultural marketing and purchasing associations of farmers, and these provisions, with a minor addition, are contained in all subsequent income tax statutes passed by Congress.



Every cooperative association that desires to ascertain if it is exempt from the payment of Federal income taxes should communicate with the Collector of Internal Revenue for its district, for the purpose of obtaining from him the necessary papers to enable the association to submit its case for exemption. A cooperative association, in applying for a ruling on its eligibility for exemption, should fully and completely answer all questions which appear on the questionnaire which it is required to file and should carefully explain its methods of operation.

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1/ Address before the Annual Convention of the National Cooperative Milk Producers' Federation, Chicago, Ill., November 10, 1941.

If, upon examination of the material submitted by a cooperative association, the Bureau of Internal Revenue finds that the association is eligible for exemption, a letter of exemption will be received from the Commissioner of Internal Revenue, or from one of his deputies. A cooperative association acts at its peril if it proceeds on the theory that, because it is a cooperative association, it is exempt from the payment of Federal income taxes.

A letter of exemption which a cooperative association receives from the Commissioner of Internal Revenue is not a guarantee that the association may not be called upon to pay income taxes; on the other hand, if an association has, without any withholding, adequately presented the facts with respect to how it is organized and how it operates and functions, it is believed there is no appreciable danger that a letter of exemption will not be given full force and effect. There are instances, of course, in which the Bureau of Internal Revenue has, in effect, set aside letters of exemption which have been issued and has called upon associations to pay income taxes for periods in which the associations assumed that they were exempt.

On investigation, I believe it will be found in every one of these instances, either that the organization in question did not completely present the facts with respect to its right to exemption, or else that the association had changed its form of organization or its operating methods subsequent to the time when it obtained a letter of exemption.

An association, to be assured that it continues to be eligible for exemption from the payment of Federal income taxes, should present to the Bureau of Internal Revenue any changes which it proposes to make in its organization papers or operating methods, if these changes are fundamental in character. Of course, an association would not have to advise the Bureau that it proposed to change its principal office from one place to another, or desired to change its fiscal year; but on the other hand, if an association, at the time it applied for a letter of exemption, was not engaged in the handling of products of nonmembers and subsequently it desires to amend its organization papers or its operating methods so as to provide for the handling of products of nonmembers, it should submit to the Bureau of Internal Revenue the proposed change so that the Bureau may ascertain if the change would affect the eligibility of the association for exemption. Letters of exemption customarily require that an association currently inform the Bureau of Internal Revenue of any material change in organization papers or operating policies.

An association acts at its own risk in making any fundamental change in its organization papers or methods; therefore, if an association is desirous of preserving its right to exemption, it should ascertain, prior to the making of a proposed change, whether

such a change would adversely affect the association's right to exemption.

Now, let us consider the conditions which must be met by a cooperative association if it is to be exempt from the payment of Federal income taxes.

(1) It must be organized and operated on a cooperative basis by farmers, for the purpose of marketing the products of members or other producers, and turning back to the members and the other producers the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or it must be formed for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses;

(2) If organized with capital stock, "substantially all such stock, other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate directly or indirectly in the profits of the association, upon dissolution or otherwise beyond the fixed dividends" must be owned by producers who market their products or purchase their supplies and equipment through the association;

(3) The dividend rate on such stock may not be fixed at a rate to exceed the legal rate of interest in the State of incorporation, or 8 per centum per annum, whichever is greater, on the value of the consideration for which the stock was issued;

(4) Such an association may accumulate and maintain only such reserves as are required by State law, or reasonable reserves for a necessary purpose;

(5) It must treat member and nonmember patrons alike in business dealings;

(6) It must so operate that the value of the products marketed for nonmembers will not exceed that of products marketed for members, and so that the value of the supplies and equipment purchased for nonmembers will not exceed the value of the supplies and equipment purchased for members, provided that the value of the purchases made for persons who are neither members nor producers shall not exceed 15 percent of the value of all of its purchases.

Let us now discuss each of the prerequisites which must be possessed by a cooperative association if it is to be exempt from the payment of Federal income taxes. Inasmuch as statutory exemptions from the payment of taxes are strictly construed, an association that is claiming exemption has the burden of showing that it comes clearly within the exemption provisions of the law. (Producers Creamery Company v. United States, 55 F. 2d 104.)

Unless an association is actually organized so as to meet the requirements for exemption, it is not eligible therefor. (Farmers Union Co-op. Co. v. Commissioner of Internal Revenue, 90 F. 2d 488; Council Bluffs Grape Growers Ass'n. v. Commissioner of Internal Revenue, 44 B.T.A. 152.) It must be organized by farmers in such a way as to show that it is to function on a mutual basis.

An association may be eligible for exemption, although it is formed to function on both marketing and purchasing bases. It must, however, be eligible for exemption with respect to each of these functions, or it is not exempt as to either. (Regulations 103 of Bureau of Internal Revenue, 237, 239.) The fact that the charter of an association may give it powers which, if they were the only powers possessed by the association, would mean that it was not eligible for exemption, is immaterial if these powers are not actually being exercised. In other words, it is the powers that are exercised by an association and not those possessed which are of controlling importance in determining its right to exemption. (Eugene Fruit Growers Ass'n. v. Commissioner of Internal Revenue, 37 B.T.A. 993.) The fact that an association must be formed for the purpose of turning back to members, or if it is to engage in nonmember business, to the members and the nonmembers, the entire amount which is realized by the association from the marketing of their products, or if the association is engaged in the furnishing of supplies or equipment, the fact that such supplies and equipment must be furnished at actual cost, plus necessary expenses, shows that associations to be exempt may not operate on a commercial basis and by so doing lose their nonprofit character.

An association is not eligible for exemption unless substantially all of its voting stock is owned by producers who market their products or purchase their supplies and equipment through the association. If an association has more than a small percentage of its voting stock in the hands of nonproducers, it is in danger of losing its right to exemption.

I do not believe that an association which has more than 10 percent of its voting stock in the hands of nonproducers can successfully maintain its right to exemption and for an association to be safe with respect to this matter, it is my opinion that the percentage of stock owned by nonproducers should be considerably less than 10 percent. Moreover, the Bureau of Internal Revenue requires that an association have a policy under which it is striving to reduce the amount of voting stock which is held by nonproducers. If voting stock is sold by an association to nonproducers, it is my understanding that exemption of the association will be denied unless the ownership of such stock is necessary to qualify a director or officer. (Regulations 103 of Bureau of Internal Revenue, 236, 238.) In theory at least, the voting stock of an association eligible for exemption must not only be held by producers but must be held by producers who are engaged in patronizing the association. This means, of course, that if a person, although

a producer, is no longer patronizing the association but continues to hold voting stock therein, that to this extent this requirement is not being met.

With respect to nonvoting stock, this may be held by anyone, but it should be remembered that this stock should not permit its owners to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends. This would apparently mean that a holder of such preferred stock should not be entitled to receive on account of it more than the fixed dividends payable thereon, plus its par value.

It is understood that under the practice of the Bureau of Internal Revenue, if an association is unable to pay a dividend on its stock in one year, there is no objection to the difference being made up in the next or succeeding years, provided the sum total of dividends paid does not in the aggregate exceed that which might be paid for the years in question.

Prior to the enactment of the Federal Income Tax Act of 1926, the exemption provisions with respect to cooperative associations did not permit them to pay dividends on stock, or to accumulate reserves. Under the regulations which the Bureau of Internal Revenue has issued, reserves may be accumulated for the erection of buildings and facilities required in the business, for the acquisition of machinery and equipment, or the retirement of indebtedness. In other words, it is apparent that reserves may be accumulated for what are essentially capital purposes. No reason is apparent why an association may not accumulate reserves for any necessary purpose, provided they are reasonable in amount; and, of course, there is no question that an association may accumulate reserves which are required by State law. If the reserves, other than those required by a State statute, are regarded as excessive, this would operate to cause the association to lose its exemption. The question of whether reserves are reasonable in amount is, at least in the first instance, a question for determination by the Bureau of Internal Revenue. The reserves which are referred to in the statute include so-called valuation reserves. Valuation reserves are made, among other things, for the purpose of meeting depreciation and obsolescence on plants and equipment. Valuation reserves, of course, may be deducted from gross income by a cooperative association. It will be appreciated that valuation reserves simply represent one of the costs of doing business. They must, however, be reasonable in amount and bear a fair relation to the purpose for which they are taken.

Many successful cooperative associations have been largely financed by the accumulation of reserves. It is not unusual for an association to begin business with a paid-in capital of not to exceed $10,000, and then for it to accumulate reserves out of earnings or savings of say $50,000 or $100,000 in the course of a few years. There is a growing belief on the part of many who are identified with the agricultural cooperative movement that all such reserve

accumulations should be allocated on the books and records of the association and to members and nonmembers alike, and that the organization papers of an association should provide for the return of such reserve contributions in the event of the dissolution of the association, or earlier if this is found practicable. The fact that, unless provided otherwise by statute or its organization papers, all of such reserves would be distributed to the persons who are members of the association at the time of dissolution, goes far to explain the need for allocating reserves to individual patrons in order to make an association as completely cooperative in character as possible. Otherwise, at least in theory, it would be possible for a member to receive from an association, upon dissolution, many times what he had contributed thereto. The opinion of a Federal District Court in Iowa, which was affirmed (Fertile Co-operative Dairy Association v. Huston, Collector of Internal Revenue, 33 F. Supp. 712, affirmed in 119 F 2d 274) by the Circuit Court of Appeals for the 8th Circuit, holds squarely that for an association engaged in dealing with members and nonmembers to be eligible for exemption from the payment of Federal income taxes, all reserves must be allocated on its books and records, and that nonmembers must be given at least the same contingent interest in such reserves as is given to members. In this connection, the following quotation is taken from the Opinion of the Circuit Court of Appeals in this case:

> "If part of the proceeds of nonmembers' products is to be used to create or maintain a surplus and to make additions to the capital assets of the association, without allowing them a proportionate distributive interest in the permanent value contributed by such surplus accumulations or capital assets additions, it must be held that the association to that extent is being operated for profit to its members, as against nonmember patrons, and that it is not exempt from taxation.
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> "The business of nonmembers may of course properly be made to carry its just share of operating expenses, actual depreciation of plant and equipment, and dividends on existing capital stock recognized by the revenue acts. But, if such business is also to be forced to bear part of the burden of accumulating other permissible surplus, and of making reasonable and necessary additions to what constitute or are equivalent to capital assets of the association, it is clear that this must be done in a manner that will permit no profit to inure to association members therefrom, on dissolution or otherwise, or else the association cannot remain exempt from taxation. Provision must at least have been made, by appropriate enabling action on the part of the association and by adequate protec-

tive entries on its books and records, for nonmembers in such a situation as is here involved to share ratably with members, in an ultimate liquidation of the association's assets, on the basis of their comparative contributions thereto."

In view of the decisions of the courts in this case, I believe every association that desires to be exempt from the payment of income taxes should give careful consideration to handling its reserves in a manner consistent with the ruling in this case.

If the reserves of an association are reasonable in amount and for necessary purposes, it is believed that an association may invest them in suitable securities, and that this would in no way affect its right to exemption.

Many associations fail to qualify for exemption on account of nonmember business. As previously indicated, not over 50 percent of the business of an association may be transacted with nonmembers and not over 15 percent of the business transacted by a purchasing association, or by an association that is both a marketing and a purchasing association, may be transacted in supplies or equipment with persons who are neither members nor producers. Some associations simply do more business with nonmembers than they do with members, or they do more than 15 percent of their supply business with persons who are neither members nor producers and, of course, either of these situations operates to cause them to be ineligible for exemption. Again, an association, in order to be eligible for exemption, must treat member and nonmember patrons alike in business dealings. If an association pays a patronage dividend to members and fails to pay one to nonmembers, the association would lose its right to exemption if it were unable to establish that the business transacted with nonmembers did not yield a profit.

In a case that arose in Nebraska, a dairy association paid a bonus to its members, but paid no bonus to nonmembers and this was held to cost the association its exemption. (Producers Creamery Company v. United States, 55 F. 2d 104.) Of course, in theory at least, it is entirely optional with an association whether it does business with nonmembers but if it elects to do business with them, the association must not discriminate against them, if it desires to be exempt. The object of this rule is to prevent an association from functioning on a commercial basis with respect to its nonmember business.

The question is sometimes asked whether an association's right to exemption would be adversely affected if it bought commodities of commercial handlers, and if it would be necessary for the association to deal with these commercial handlers on the same basis as with its members. It is my understanding that, under the practice which the Bureau of Internal Revenue has followed, if such purchases

from dealers are made because of necessity, and are distinctly minor in amount, such transactions will not be regarded as adversely affecting the right of an association to exemption, even though the dealers are not dealt with on the same basis as members. On the other hand, attention is called to the fact that inasmuch as the statute requires that an association, to be eligible for exemption, must be organized for the "purpose of marketing the products of members or other producers," it is believed that an association might lose its exemption if it purchases, in substantial amounts, commodities of the types which it is engaged in handling from dealers or on exchanges, and not from producers. In any event, if the purchases from dealers are substantial in amount, it would seem clear that an association must accord such dealers the same treatment as its members in the payment of patronage dividends, or in the allocation of earnings placed in reserves, so that the principle of equality of treatment is not violated. In our study of this particular phase of the subject, we have found only one adjudicated case that is directly in point. In this case, it appeared that the cooperative had purchased "small quantities of poultry and eggs from dealers" as well as from producers in order to facilitate the marketing of the balance of the products which it handled, and the products which were so purchased were not handled at a profit. It was held that this did not operate to deprive the association of its exemption. (Producers' Produce Company v. Crooks, 2 F. Supp. 969. See also Eugene Fruit Growers Association v. Commissioner of Internal Revenue, 37 B.T.A. 993.)

Under the Regulations of the Bureau of Internal Revenue, every association that desires to be exempt must keep permanent records with respect to its member and nonmember business, (Regulations 103 of Bureau of Internal Revenue, 236, 238) and associations have been denied exemption because of their failure to keep such permanent records.

If a cooperative association attempts to differentiate among its members in regard to returns to them, other than on the basis of the quality of products which are received, or because of difference in handling costs, I believe there is a basis for the view that this might adversely affect the right of an association to exemption. The Board of Tax Appeals has said (Farmers Union Co-operative Oil Company v. Commissioner of Internal Revenue, 38 B.T.A. 64, 71):

> "The evidence negatives the fact that petitioner was operating on a cooperative basis, either as among members alone or as between its members and nonmembers."

In other words, equality of treatment as among members and as among members and nonmembers, except for differences due to natural causes, would appear to be a prerequisite to exemption.

The question is sometimes asked whether the fact that a cooperative association has subsidiary corporations would affect its right to exemption. If an association is simply doing, through the medium of a subsidiary corporation, what it could do directly without losing its exemption, it appears clear that such a subsidiary would not adversely affect the association's right to exemption. In such a case, the subsidiary is little more than an incorporated department of the association. On the other hand, if a subsidiary is doing things which an association could not do directly and be exempt, a much more serious problem is presented. In the first place, if such a subsidiary were capitalized out of the reserves of the association, the question would arise whether these reserves had been accumulated for a necessary purpose. It is hard to believe that it can be held that the use of reserves for capitalizing a subsidiary to do what an association could not itself do and be exempt would be held to be a necessary purpose. Moreover, if an association were simply engaged in the conduct of a commercial business through the medium of a subsidiary corporation, this on its face would seem to raise a serious question as to whether it would not operate to cost an association its right to exemption. Each case would probably have to be dealt with on its merits and if an association in fact was not deriving substantial income, directly or indirectly, from the existence of a subsidiary, this fact might alleviate the danger to its right to exemption.

The statute provides that "Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption * * *." In view of the foregoing provision, in any instance in which it has application, the business done by an association for the United States or any of its agencies will not adversely affect the right of the association to exemption. For the provision to have application, however, the association must actually be doing business for the United States or one of its agencies. If an association is merely selling commodities to the United States or one of its agencies, this would not appear to be sufficient. On the other hand, the language would appear to include an association engaged in the acquiring or selling of commodities for the United States or one of its agencies, in accordance with a contract authorizing the association to do so. Likewise, the storage of commodities by an association for the United States or one of its agencies would also appear to come clearly within the terms of the language. The provision has no application to a State or any subdivision thereof.

An association is either exempt from the payment of Federal income taxes, or it is not exempt; there is no such thing as partial exemption. (Farmers Union Co-operative Oil Company v. Commissioner of Internal Revenue, 38 B.T.A. 64.) It may be that an association that is not eligible for exemption may, because of provisions in its bylaws or in its marketing contracts, be allowed to deduct or exclude, in computing the net income on which taxes are to be paid, amounts distributed as refunds or patronage dividends but this is

not an exemption; it is simply one of the deductions or exclusions that may be made in computing the income taxes of an association.

Subject to certain conditions, organizations that are not exempt from the payment of income taxes have been allowed by the Bureau of Internal Revenue, for many years, to deduct cash patronage dividends paid to their patrons in computing the amount on which they are required to pay income taxes. (C.B. 1937-1, 56.) For an organization to be in a position to deduct such patronage dividends, its organization papers should show that it was really intended to function on a cooperative basis, and its bylaws should provide for the payment of such patronage dividends. In addition, the board of directors of the association should adopt a resolution declaring a patronage dividend before the expiration of the taxable year, and directing its officers to ascertain and pay the amount of the patronage dividends as soon as practicable after the close of its fiscal year. Unless the conditions just specified are met, (C. B. 1937-1, 56) it is at least doubtful that the Bureau of Internal Revenue would permit the deduction of patronage dividends, and in a recent case involving a cotton gin (Peoples Gin Company v. Commissioner of Internal Revenue, 118 F. 2d 72), the Bureau denied the right of an association to deduct patronage dividends which it had paid where the bylaws providing for the payment of such dividends was not adopted until after the earnings had actually been made, and the Board of Tax Appeals and the Federal court to which the case was appealed upheld the action of the Bureau.

In at least one case decided by a circuit court of appeals (Cooperative Oil Association v. Commissioner of Internal Revenue, 115 F. 2d 666), the court, in dicta, expresses serious doubt as to the right of an association to deduct patronage dividends if the association is not under a positive obligation to pay such dividends, and points out that there is no statutory authority for allowing such deductions.

If the bylaws of a nonexempt organization make it mandatory on the organization to pay a patronage dividend, to be determined in accordance with a formula contained in the bylaws, or if corresponding provisions are included in the contracts of an association, so that there is a firm obligation on the part of an association to ascertain as soon as practicable after the close of its fiscal year the amount of the patronage dividends which are payable to its members or patrons, then it appears to be clear that an association has the legal right to deduct the patronage dividends which are so paid in computing its income taxes. Under the circumstances just detailed, the obligation of the association to pay patronage dividends amounts to a debt. If an association that is nonexempt, therefore, desires to be in a position where there would appear to be no doubt regarding its right to deduct patronage dividends, its organization papers should show that it is under a positive obligation to ascertain the amount of such patronage dividends and to pay them. (Anamosa Farmers Creamery Company v. Commissioner of Internal Revenue, 13 B.T.A. 907.)

Whether a nonexempt organization may deduct, in computing its income taxes, earnings kept in the business for increasing its capital, is not entirely clear, and would appear to depend on the specific facts involved.

In a case which arose in Iowa (C.B. 1938-2, p. 127), the Bureau of Internal Revenue held that in view of the Iowa statute and the way in which the associations in question were organized, amounts which were retained by associations, but which were allocated to members and represented by participation certificates which were issued to them were deductible to the extent that they represented earnings accruing on member business which were regarded as contributions to capital. In a recent case with which most of you are familiar (Midland Cooperative Wholesale v. Commissioner of Internal Revenue, 44 B.T.A. 824), involving the Midland Cooperative Wholesale, it appeared that this association had credited patrons with the amount of the earnings accruing on account of their patronage, and that this was done in pursuance of a resolution adopted by the board of directors of the association during the taxable year. The association was allowed to deduct these amounts, but apparently this was permitted by the Board of Tax Appeals on the theory that the amounts in question were debts, because that Board said the amount involved "could in its opinion have been withdrawn by the members at any time." The Board of Tax Appeals attached considerable significance to provisions appearing in the Minnesota statute under which the association was organized, with respect to the manner in which earnings of an association incorporated under this statute were to be distributed.

It has been held that (Valpariso Grain and Lumber Company v. Commissioner, 44 B.T.A. 125) in computing the deduction which a nonexempt association may make in arriving at taxable net income, dividends on capital stock must be deducted from gross income before determining the amount of patronage dividends accruing on member business.

The Board of Tax Appeals has held (Farmers Union Cooperative Exchange v. Commissioner of Internal Revenue, 42 B.T.A. 1200) that, where a nonexempt association doing business with members and nonmembers is entitled to deduct patronage dividends paid to its members, this may be done in such a way that the amount payable to members is undiminished by the amount of Federal taxes and penalties.

Of course, in computing the taxable net income of a nonexempt association where patronage dividends are paid only to members and are not paid to nonmembers, such patronage dividends may be deducted only to the extent that the earnings represented by such dividends accrued on the business of members. (Fruit Growers Supply Company v. Commissioner of Internal Revenue, 56 F. 2d 90.) In the absence of convincing evidence to the contrary, the Bureau of Internal Revenue proceeds on the theory that the business done with members and nonmembers is equally profitable. (C. B. III, 287.)

It will, of course, be appreciated that a cooperative association may be exempt from income taxes one year and be taxable the next. It follows then that the officers of an association, if it is to be eligible for exemption, must keep the prerequisites for exemption in mind so that the association will be organized and operated at all times in such a manner as to meet those requirements.